CANADIAN TAX Highlights

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FA Rules: Trial Balloons

At the Foundation's recent international tax seminar in Calgary, a Finance official identified several foreign affiliate (FA) issues and possible approaches to dealing with them. It is not clear whether Finance will act on these issues or whether the issues (highlighted and summarized below) simply reflect some ideas that Finance has considered.

■ **CFA status.** Legal control is too narrow a concept, and controlled FA (CFA) status is easily avoided by using effective control. Also, whether relationships are non-arm's-length in fact is difficult to discover and prove. One solution is to eliminate the distinction between FA and CFA; one definition of FA might apply for all purposes, based on a 10 percent votes and value test.

■ **Deemed active business income (ABI).** The ABI flowthrough rules allow income from property to be deemed ABI even if it is not taxed in the FA. The basic thrust of subparagraph 95(2)(a)(i) is justified: it is often commercially necessary or desirable for parts of an active business to be carried on in separate legal entities. But the wording may receive an inappropriately broad interpretation by the courts, and taxpayers are seeking such. Subparagraph 95(2)(a)(ii) appears justified to ring-fence the total ABI of an affiliated group. Comparable rules do not exist in most other countries. The rules are being widely used to incur interest costs in Canada through double-dip financing structures, and some form of same-country limitation may be needed.

■ **Excluded property.** Taxable capital gains (TCGs) and allowable capital losses (ACLs) from the disposition of FA shares and partnership interests are excluded from FAPI and included in taxable surplus (TS); this effectively constitutes an exemption because TS dividends are rarely paid to a Canadian corporation. The treatment seems unnecessary and overly generous: an election allows gains on shares to be treated as dividends from underlying surplus. Direct investment by a Canadian taxpayer compares unfavourably: the effect is to encourage Canadian taxpayers to structure the ownership of their offshore operations through a holdco in a low-tax jurisdiction. To correct this inequity, the excluded-property definition could exclude partnership interests, FA shares, and property sold as part of an asset sale where all or substantially all of a business's assets are sold. Deferral could be provided by replacement-property rules.

■ **Interest deductibility.** Canada's tax base is being eroded: interest on FA investments is deductible, and exempt surplus (ES) dividends are not taxed in Canada. Several methods for determining the appropriate restriction on interest deductibility have been considered, but each has significant technical or practical difficulties.

■ **Excess double-taxation relief.** Finance is reviewing the ES concept—which assumes a foreign tax paid at rates and on a base equivalent to Canada's—because often no foreign tax is paid on the exempt earnings. Instead, all surplus could be TS, or jurisdictions could be designated for ES treatment. A TS approach would track underlying taxes paid, achieving simplicity by obviating the need to designate and monitor foreign countries' tax systems. Under a designation approach, all dividends paid by FAs in designated countries would be exempt from Canadian tax; a TS approach would apply to other FAs. The current exemption/credit system would shift from a transactional to an entity approach. Designation would apply to a country with a tax rate and base approximating those in Canada. Erosion of the Canadian tax base is thus prevented, but the system breeds complexity.

Many of these approaches would have a significant negative impact on Canadians doing business abroad. It is hoped that Finance will fully consult with interested parties and give due weight to the effect on international competitiveness before making significant changes to Canada's FA system.

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In This Issue

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Subpart F White Paper

The US Treasury recently issued a 200-page plus white paper on the status of the subpart F rules. Under subpart F, US citizens or residents with at least a 10 percent voting

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interest (US shareholders) in a foreign corporation owned more than 50 percent by vote or value by US shareholders (CFC) may be taxed currently on the CFC's undistributed earnings. Subpart F is one of several anti-deferral regimes aimed at unrepatriated earnings, such as passive income or income from certain transactions with related corporations.

The white paper reaffirms that one of subpart F's policy goals is capital export neutrality—the same tax result whether a US taxpayer invests at home or abroad. The United States taxes its residents and citizens (regardless of residency) on worldwide income. In theory, a US taxpayer's income from both domestic and foreign investments is subject to US tax, but the United States has no jurisdiction to tax foreign corporations on non-US-source earnings. Without some type of anti-deferral system, a US taxpayer might find that foreign corporate investment is tax-favoured until the earnings are repatriated.

Subpart F came into force in 1962 and has not been significantly altered since. Treasury has raised serious questions about the viability of subpart F in today's economic environment; although the white paper discusses some proposals, it stops short of any concrete proposal for reform. Treasury acknowledges that when subpart F was enacted, the "foreign business paradigm" was the manufacturing facility. The growth of service businesses, electronic commerce transactions, and the use of hybrid entities—all of which, Treasury states, pose challenges to the effectiveness of subpart F—nonetheless apparently do not compel a different approach. Moreover, Treasury rejected the often-cited criticism that subpart F hinders the competitiveness of US-owned multinationals.

Subpart F can cause planning havoc for families with US citizens or residents or for foreign businesses that have US-citizen or US-resident owners. However, the other US anti-deferral regimes are also of concern, notably the foreign personal holding company (FPHC) and passive foreign investment company (PFIC) regimes, which can produce severe US tax consequences for US citizens or residents with a direct or indirect interest in such corporations. For example, even a US citizen or resident who is a discretionary beneficiary of a trust that owns FPHC or CFC stock may suffer current US tax on some or all of the trust's allocable share of the corporation's undistributed income or a penalty tax on later distribution under the PFIC or foreign trust rules. The future of subpart F and possibly the other anti-deferral regimes may be unclear, but significant near-term change appears unlikely. Continued careful consideration should be given to the rules' potential impact on structuring business and investment holdings if a US citizen or resident is part of the mix.

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Attributing Profits to PEs

No consensus exists among OECD member countries as to how profits should be attributed to a permanent establishment (PE) under model treaty article 7. Technological advancements that have facilitated the conduct of international business such as e-commerce and financial products trading have made the need for a common interpretation more pressing. The OECD has attempted to develop a generally accepted approach by way of a working hypothesis (WH) to test and analyze both the extent to which a PE may be treated as a hypothetically distinct and separate enterprise and how OECD transfer-pricing guidelines may apply to attribute profits to a PE under the arm's-length principle. The OECD discussion draft, released on February 8, 2001 for public comment, contains the results of testing the WH on PEs generally and on PEs of banks.

The draft states that "profits to be attributed to the PE are profits [it] would have earned at arm's length as if it were a distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle"; the WH thus adopts the "functionally separate entity approach." The draft rejects the "relevant business activity approach," which limits relevant profits to those of the business activity in which the PE participates and requires the host country to attempt a determination of the enterprise's worldwide profits from the "relevant business activity." Application of the transfer-pricing guidelines should ensure an arm's-length return for the PE's functions as a comparable independent enterprise would, considering the assets used and risks assumed. The dealings between the PE and the whole enterprise must be compared with transactions between independent enterprises, analogizing the comparability analysis approach described in the transfer-pricing guidelines; analogous documentation requirements also apply.

The discussion draft notes that in attributing taxable profit to a bank's PE, appropriate allocation to the PE of the equity (free capital) of the whole enterprise should be emphasized because capital adequacy may affect the bank's profit level significantly. Free capital should be attributed to the PE under the BIS ratio approach: the bank's regulatory capital is attributed in accordance with the attribution of risk, based on the proportion of the PE's risk-weighted assets to the whole enterprise's.

The need for consensus is crucial. For example, the United States tends to consider that its domestic law's formulaic approach can simply override the separate enterprise language in tax treaties. However, in *National Westminster Bank* (44 Fed. Cl. 120 (1999)), the taxpayer successfully championed the separate entity approach, winning an interest expense deduction on a notional loan between the US branch and the UK head office. In *Cudd*

Pressure (98 DTC 6630), one FCA judge indicated that such notional expenditures may be deductible if the arrangements are properly structured and documented. The CCRA disagrees, saying that a person cannot incur an expense dealing with itself: only actual expenses are allocable to a PE. The OECD discussion draft WH recognizes notional expenses: for example, lease payments made on assets leased from a head office in another jurisdiction may in some cases be deducted in computing a PE's profits.

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Shifting Targets

Preliminary data on personal income tax returns for the 1998 tax year help explain the shape recent federal tax cuts took.

Almost two-thirds of taxpayers were in the lowest tax bracket when the tax rate schedule was introduced in 1988; 10 years later, only about half were. Over one-quarter of federal income tax came from that bracket in 1988, but only 14 percent in 1998. The table shows how the shift in the distribution of taxpayers and income has changed the distribution of federal and provincial tax revenues. In 1988, almost 1.5 percent of taxpayers earning more than $100,000 provided 16 percent of all federal income tax revenues, but 10 years later the percentage produced by the same income group doubled to 3 percent of all tax returns, and its share of tax increased to 27 percent. Taxpayers with incomes below $30,000 provided nearly 27 percent of federal income tax in 1988, but less than 14 percent in 1998.

Percentage distribution of	Under $30,000	$30,000 to $60,000	$60,000 to $100,000	Over $100,000
Taxable returns				
1988	65.7	29.0	3.9	1.4
1998*	51.1	36.3	9.5	3.0
Taxable income				
1988	41.2	40.4	9.2	9.2
1998*	26.1	39.8	17.7	16.4
Federal income tax				
1988	26.9	44.1	12.9	16.0
1998*	13.8	37.2	22.2	26.7
Provincial income tax				
1988	24.9	43.7	13.1	18.3
1998*	9.8	32.6	22.2	35.4

* Preliminary figures shown for 1998.

Provincial personal income tax collections, for all provinces except Quebec, were more concentrated than federally at the higher income levels. In 1988, 18 percent of provincial revenue came from those with incomes above $100,000, close to the federal percentage. In 1998, the share contributed by the top end amounted to 35 percent, well above the comparable federal figure. In 1998, less than 10 percent of provincial taxes came from those with incomes below $30,000, a change from 25 percent a decade earlier.

These figures show the extent of the shift in income distribution in the first 10 years of the tax system set up in 1988: the increase in the number of taxpayers in the $30,000 to $100,000 income range—from 33 to 46 percent—and the doubling of the numbers in the top bracket meant that far more taxpayers were subject to the relatively high marginal tax rates of the 1988 tax reform. It should come as no surprise that the federal government addressed these groups in its most recent round of tax cuts.

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OECD on Consumption Taxes

After a two-year e-commerce study, the OECD working party on consumption taxes issued its principal conclusions and recommendations. The draft report reveals the first details of the OECD's analysis of the measures it considers necessary to maintain fundamental taxation principles such as neutrality, certainty, and simplicity.

An October 1998 ministerial conference in Ottawa discussed broad e-commerce issues and endorsed the fundamental principle that taxation should occur in the jurisdiction where consumption takes place. The draft recommendations build on that principle for business-to-business (B2B) and business-to-consumer (B2C) transactions, particularly for the delivery of services and intangibles from a remote location. A number of alternative determinants of the place of consumption for B2B transactions are reviewed, including the location of the supplier's profit-generating activities and the place of contract. Ultimately the location or business presence of the recipient—perhaps the headquarters, a branch, a registered office, or the seat of economic activity—was favoured as being "workable and well grounded." If several locations exist, the relevant business presence is the establishment to which the supply is made. Flexibility prevents taxpayers from avoiding tax by routing transactions through different establishments. The report concludes that a B2C place of consumption is the recipient's usual jurisdiction of residence, or where he or she spends the majority of time in the case of more than one jurisdiction. Inherent difficulties in identifying the jurisdiction of virtual customers and the absence of technology to determine such with any precision means the B2C issue may be revisited.

An analysis of the effectiveness of existing tax collection mechanisms and other options concludes that the most feasible B2B collection method is self-assessment or reverse charge: recipients must determine the tax on imported taxable services and intangibles and remit it directly to the taxing authorities. Self-assessment is embodied in Canadian GST and provincial retail sales tax systems, but in the B2C context, the report concludes that the only coherent short-term solution is to encourage vendor registration for collection. Non-resident suppliers should be encouraged to register through a simplified electronic procedure using a basic level of information and reporting, but they could only recover tax via regular registration, which entails filing regular returns.

The report includes some overall simplification initiatives, including standardizing invoice formats and related procedures, audit requirements, and VAT or sales tax returns, and facilitating and promoting electronic VAT reporting and record-keeping systems. In recognition of the further work required in several key areas, comments from interested parties are invited before April 30, 2001.

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Stock Option Share Ordering

The December 21, 2000 draft legislation includes myriad new rules for the acquisition and disposition of shares under a stock option plan. Particularly noteworthy are rules for ordering the disposition of identical properties.

The CCRA's *Income Tax Technical News* no. 19 announced an alternative method for an employee to determine the ACB of shares acquired on the exercise of stock options while holding other identical shares: the employment benefit on the acquisition attached to the shares sold and was not averaged over the cost of all the identical properties. Finance has now legislated specific ordering rules governing the disposition of securities so acquired. The interaction of these rules with rules allowing a deferral of an employment benefit on certain shares complicates the calculation of the optimal result—for example, if an employee exercises a number of options simultaneously and sells some shares. Generally a first-in, first-out rule applies for identical properties, but shares subject to the new deferral rules are deemed acquired after those that are not—continuing the deferral if other identical properties are sold—and are deemed acquired in the order the related stock option agreements were made. A new rule allows a taxpayer to designate certain shares as being sold, if the disposition takes place no later than 30 days after the option's exercise and no other identical shares are acquired or disposed of after the exercise and before the sale. The taxpayer makes the designation in his or her tax return for the year of disposition by calculating the applicable capital gain or loss.

Consequential changes include adding the employment benefit arising on the options' exercise to the ACB of the share when acquired, even if no benefit was included in income (for shares acquired after February 27, 2000). In addition, specific pools of shares are carved out from the identical-property rules (proposed subsection 47(3))—such as shares subject to the new deferral rules and designated shares—and their cost and ACB are not averaged with other identical properties.

A few guidelines can be gleaned from these new rules.

- A sale of stock option shares within the 30-day designation limit allows the most recent acquisitions to be designated as the shares being sold instead of previously acquired shares with possibly larger inherent gains.
- For options exercised in 2000, employees have until 60 days after the enabling legislation receives royal assent to file with their employers the election to claim the deferral. For 2001 and after, the election is due in January following the year of exercise, facilitating calculation of the election's tax implications.
- The election to defer can be revoked. For shares acquired in 2000, the revocation deadline is 60 days from the day the legislation receives royal assent, which is unlikely to be given before summer to the as yet untabled draft legislation.
- If the employee sells shares after the 30-day limit, be aware of the ordering rules and their implications. A pool of shares from the earlier exercise of an option ineligible for deferral is deemed sold first. If the employee also holds shares eligible for deferral, the interaction of the disposition and a deferral should be examined before making a deferral election.

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Ontario Flowthrough Proposals

Ontario's May 2000 budget proposals, designed to rejuvenate the appeal of mining flowthrough share financings in Ontario to individual investors, provided a 30 percent bonus depletion deduction for qualifying grass-roots Canadian exploration expense (CEE) in the province (OCEE). The federal October 18, 2000 mini-budget responded with a 15 percent non-refundable tax credit for individuals (other than trusts) either alone or as a partner for CEE under flowthrough arrangements on or after that date and before 2004; cumulative CEE in subsequent years is reduced by the federal credit. On December 6, 2000, the Ontario Ministry of Northern Development and Mines announced that, effective from the federal mini-budget date, Ontario's incentive would be harmonized with the federal and would take the form of a 5 percent tax credit for OCEE.

A flowthrough share investor reaps income tax benefits for expenditures deemed incurred by him or her when they are made and renounced by the corporation funded by the subscription proceeds. The flowthrough share's ACB is deemed to be nil, and all sale proceeds of shares that are capital property are capital gains; the election to treat as capital any gains and losses from Canadian securities does not apply. The final Ontario rules are expected to generally parallel existing federal rules—but the renouncing corporation must have an Ontario PE—and require that a share be issued pursuant to a flowthrough share agreement by a principal business corporation that agrees to incur OCEE for the purpose of determining the existence, location, extent, or quality of a mineral resource (other than a coal, bituminous sand, or oil shale deposit) for the consideration received. OCEE more or less mirrors the federal grass-roots definition of mining CEE in subsection 66.1(6), paragraph (f) of the definition, but OCEE must be incurred in Ontario. Specific allowance is made for direct expenses related to labour and field supervision, contractor's and consulting fees, supplies and equipment rental, and direct expenses, to the extent generally allowed as CEE and related to transportation of supplies, shipment of samples, assays and chemical analyses of samples, food and lodging, (de)mobilization of equipment and crew, and transportation of persons within Ontario, including direct project overhead but not head-office costs. Certain exclusions exist, such as expenses related to digging test pits and preliminary sampling, CDE (in mining projects, the purchase price of the mining property), or any related

Impact of Ontario Tax Credit Proposals for a Flowthrough Share

Year	(A) Investment and CEE deduction	Tax rate[a]	(B) Tax savings on CEE	(C) Tax credit 20%[b]	(A−(B+C)) After-tax cost of investment
	$	%	%	$	$
1999	1,000	48.75	488	nil	512
2001	1,000	46.41	464	200	336
2002	nil	46.41	(92)	nil	92[c]
Total					428

Break-Even Analysis

Year	(A) Break-even proceeds	Gain inclusion rate[c]	Taxable gain	(B) Tax[c]	(A−B) After-tax proceeds
	$	%	$	$	$
1999	808	75	606	296	512
2001	557	50	278	129	428

[a] Ontario resident—highest marginal rate based on tax proposals as of November 15, 2000. [b] 15% federal credit plus 5% Ontario credit. [c] Assumes no CEE incurred in 2002. Tax on recapture for $200 tax credit claimed in 2001.

expense reasonably related to a mine, owned by the taxpayer or not, that has come into production in reasonable commercial quantities or related to a potential or actual extension thereof. There are also exclusions for CEDOE, financing expenses, and outlays or expenses included in depreciable property's capital cost.

A flowthrough share investment is prudent only if the return exceeds the net funds invested after tax. A $1,000 OCEE flowthrough investment in 2001 by an Ontario taxpayer taxed at the highest marginal rate has about a $336 after-tax cost. If no OCEE is incurred in 2002, the additional tax on CEE recapture of tax credits in 2002 is about $92. For the investor to break even, the proceeds on the shares' sale must approximate $557, a decrease of about 30 percent compared to CEE incurred in 1999 as a combined result of the new measures and federal and Ontario budgetary reductions in income tax rates

JEFF MACNELLY'S SHOE by Chris Cassatt and Gary Brookins

and capital gain inclusion rates. The investor's gain or loss is also affected by subscription premiums paid and by subsequent changes in the securities' FMV. If anticipated tax deductions reduce regular income taxes below AMT, the cost of either paying AMT or forgoing the tax deductions must also be taken into account.

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Foreign Spinoff Proposals

Certain share distributions by US corporations—spinoffs—are not taxable to US shareholders, but they are taxable dividends to Canadian shareholders. Under proposed section 86.1, shares received on a foreign spinoff may not be taxable if, inter alia, common shares of a corporation resident in the same jurisdiction as its former parent are distributed and the distributing corporation voluntarily provides certain information to the CCRA.

The jurisdiction where the distributing corporation resides must not impose tax on the distribution to shareholders resident there, a fact that must be confirmed in the information filing with the CCRA. It is not clear whether the proposal permits exceptions to a general rule that no shareholder be taxable: this is not an issue under the apparent focus of the proposal, Code section 355, which provides that no US shareholder is taxable. Furthermore, the class of shares in respect of which the distribution is made must be "widely held" and "actively traded" on a prescribed exchange—a fact that must also be confirmed in the filing—but the terms are not defined and appear to be borrowed from proposed section 94.1. Informally, Finance officials indicate that those terms are intended to exclude, respectively, situations where a (group of) Canadian shareholder(s) has effective control and essentially directs the spinoff and those where the corporation is listed but not trading regularly. It is not clear that the policy concerns are addressed by those terms, nor is it clear why Canadian control of the distribution is offensive.

The taxpayer must file an election and, along with the distributing company, file information with the CCRA, leaving the tax fate of the Canadian shareholder hanging on a filing by the foreign corporation over which it has no control. Informally, Finance and CCRA officials say they anticipate that Canadian brokerage firms will approach the foreign corporations on behalf of their clients to ensure cooperation. However, as a practical matter, the filing and its timing might not receive the foreign company's full attention: shifting the entire reporting responsibility to the Canadian shareholder may be more reasonable. The taxpayer's election and supporting information must be filed with its tax return for the year, and the foreign corporation's by the end of the sixth month after the first relevant share distribution. Thus if the first distribution is made on December 31, the taxpayer may face an uncertain filing position on the election due date. Informally, the CCRA says that before filing the election the taxpayer must confirm that the transaction is not taxable to the foreign jurisdiction's resident shareholders and that the distributing corporation will file timeously, but it is not clear what constitutes satisfactory confirmation. Related public disclosure documents should evidence the foreign tax treatment, but a taxpayer may neither know nor be able to demonstrate whether or when the foreign corporation will file.

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Itinerant Purveyors of Knowledge

In *Collin & Waite*, the TCC found that teachers hired on a course-by-course basis were independent contractors, not employees. The TCC applied the accepted test, but noted that the "essential problem in this case . . . did not exist to any extent even 20 years ago. The workers' real tools were their knowledge." Such cases may proliferate as the trend to freelance work grows, especially in knowledge-based fields such as law, accounting, and technology, where practitioners were traditionally salaried employees.

Collin, Waite, and their corporation (the taxpayers) contested their liability for employee source deductions for Worker's Compensation Board (WCB) certified instructors (the workers). The taxpayers' business provided first aid and safety-training prep courses for WCB exams; they determined demand for courses, registered students, and hired workers at a flat pay rate per course. The TCC looked to the *Wiebe Door* tests to determine employee or independent contractor status: (1) degree of control exercised by the alleged employer (both taxpayers and workers were controlled essentially by the WCB or similar agencies); (2) ownership of tools (the workers provided their own slides and materials to work up and teach each class); (3) chance of profit and risk of loss (both taxpayers and workers could profit and risked minimal losses); and (4) integration of the alleged employee's work into the alleged employer's business (the workers taught similar courses for others). The FCA in *Wiebe* noted that perhaps the best synthesis of these tests is in the English case *Market Investigations*: "Is the person who has engaged himself to perform these services performing them as a person in business on his own account?" In *Collin*, the workers supplied services to a number of institutions, prepared lectures at their own facilities on their own time with their own tools, paid their own fees and purchased their own materials to qualify as teachers, applied for work at various institutions in the hope of being hired, and negotiated a flat fee for each job.

The TCC said that "like the original teachers of the middle ages or Roman or Greek times [these workers] were itinerant purveyors of knowledge," in the business of providing a teaching service to any taker. The taxpayers also had their own business as brokers to bring together students and teachers or merely to facilitate their arrangements.

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Canada-US Hybrids

A hybrid entity is regarded as a corporation in one jurisdiction and a partnership in another. Several hybrids are used in Canada by US taxpayers.

S corporation. An election for US tax purposes makes an S corp a flowthrough entity, but it is a corporation for Canadian tax purposes (*Matheson* (1963), Tax ABC 178). An S corp benefits from the Canada-US treaty because its income is taxable at the corporate level unless it elects. To avoid double taxation, a Canadian-resident US-citizen shareholder of an S corp may request the Canadian competent authority to deem it a controlled foreign affiliate (CFA) earning FAPI, bringing the timing of the Canadian tax into line with the US tax, from the distribution of dividends to when the income is earned.

Limited liability company. The CCRA has ruled that LLCs formed in Colorado, Florida, Kentucky, Michigan, New York, Wyoming, and Texas are corporations for Canadian tax purposes; for US purposes they are partnerships or disregarded if there is a single member. Because an LLC is not liable to US tax, the CCRA says it cannot reap treaty benefits unless it elects for US purposes tax to be a corporation, making an LLC an inefficient entity for investing in Canada: an LLC attracts 25 percent Canadian withholding tax on all passive income and Canadian corporate and branch tax on any Canadian business carried on, whether it has a PE or not. An LLC may be deemed resident in Canada if its central management and control resides here. An LLC with a Canadian-resident shareholder is a CFA earning active business income (ABI) or FAPI. A Canadian corporate taxpayer is not subject to Canadian tax on exempt surplus (ES) dividends sourced from certain ABI, nor is there any credit for underlying US tax. Foreign tax credits may be mismatched if the LLC earns FAPI: the LLC's income attracts US partnership withholding, but the CCRA says it does not qualify to offset Canadian tax on the FAPI because the tax is the shareholder's and not the LLC's liability. Nor is there any credit (subsection 126(1)) or deduction (subsection 20(12) or paragraph 113(1)(b)), but there may be a deduction on the dividend's distribution (paragraph 113(1)(c)). If a US C corporation is interposed as the LLC's owner and its earnings are distributed as earned, the C corp is subject to US tax on its share of the LLC's income; the tax is deemed to be foreign accrual tax for Canadian purposes; and the C corp is considered to have received a dividend. On a dividend from the C corp, Canco may deduct up to the dividend amount under paragraph 113(1)(b) and subsection 91(5). The interposition of a US C corp is the preferred method of investing in at least 10 percent of the shares of a US LLC carrying on an active business or if the LLC is a CFA earning FAPI. A Canco may interpose a US LLC to hold a US opco in order to shelter the capital gain on a sale of opco shares under article XIII and the excluded-property rule in Canada; one-half of the gain may be repatriated tax-free as an ES dividend, and tax on the balance is deferred until distribution. A deduction may be available for the excess over 15 percent of an individual's tax on his or her share of an LLC's FAPI; the balance may be eligible for a credit or deduction (section 126 and subsection 20(12)).

Business trust. A valid trust must exist under Canadian trust law, which requires certainty of intention on the part of the settlor to create a trust and the identification and ascertainment of beneficiaries by name or class. Planning opportunities may be created by a structure that is a trust for Canadian tax purposes but ignored for US purposes.

Nova Scotia unlimited liability company. An NSULC is a corporation for Canadian tax purposes; for US purposes it is a partnership if there is more than one member and is otherwise disregarded. An NSULC's worldwide income is subject to Canadian corporate tax, which should generate US foreign tax credits. An NSULC is a corporation for treaty purposes for payments from Canada. Such an entity is useful for Americans if a Canadian business is being set up or acquired, or to finance Canadian operations, to acquire Canadian real estate, or to plan for passive Canadian investments, and for pre-departure planning for a Canadian-resident, non-US citizen moving to the United States.

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ECP Inclusion Rates

The February 28, 2000 federal budget and the October 18, 2000 mini-budget resulted in three different inclusion rates for dispositions of eligible capital property (ECP) in calendar 2000, depending on the rate at the taxpayer's year-end, not at the time of disposition. Furthermore, although the gain arising on disposition is included in

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income at the two-thirds or one-half inclusion rate, the income inclusion on recapture of cumulative eligible capital (CEC) claims is at 100 percent. And additions to the ECP pool are maintained at three-quarters of eligible capital expenditures (ECEs). The table illustrates the application of the new inclusion rates, assuming the acquisition of ECP for $100 in year 1 and its sale for $1,000 in year 2. The negative balance in the CEC pool, net of recapture, is multiplied by a factor of eight-ninths for taxation years ending between February 28 and October 17, 2000 inclusive and two-thirds for taxation years ending thereafter, to arrive at the two-thirds or one-half income inclusion for gains from the disposition of ECP.

	After Oct. 17, 2000	Feb. 28, 2000 to Oct. 17, 2000
	dollars	
Original cost	100	100
CEC pool addition (¾ rate, both)	75	75
CEC deduction, year 1	(5)	(5)
CEC balance, year 1	70	70
Proceeds of disposition in year 2: $1,000		
Amount credited to CEC pool at ¾	(750)	(750)
Negative balance in CEC pool	680	680
Less recapture	5	5
Gain	675	675
Gain inclusion (⅔, 8/9 rates)	450	600
Plus recapture*	5	5
Total income inclusion	455	605
Proof of income inclusion:		
Proceeds	1,000	1,000
Cost	(100)	(100)
Gain	900	900
Gain inclusion (½, ⅔ rates)	450	600
Recapture	5	5
Total income inclusion	455	605

* To a maximum of the negative balance in the CEC pool.

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Foreign Tax News

OECD

Seychelles has committed to eliminate harmful tax practices with its removal from the OECD blacklist by July 2001. The OECD-Commonwealth Working Group on Tax Co-operation held a second round of meetings in Paris on March 2, 2001, aimed at global cooperation on tax matters by 2005. (See "Foreign Tax News," *Canadian Tax Highlights*, December 27, 2000, at 96.) Simon Woodside of Fiscal Affairs discusses taxation of e-commerce in the most recent edition of the *Observer*, which can be accessed on the OECD's Web page: http://www.oecd.org.

Australia

Draft thin capitalization rules, effective July 1, 2001, include extension of the rules to both Australian operations of inbound and outbound investors; a limitation on the investor's total debt of Australian operations and not just foreign debt; and a new test distinguishing debt from equity. New rules apply for authorized deposit-taking institutions (ADIs) to ensure a minimum equity capital in Australian operations—the lesser of the safe-harbour capital amount (7 percent of the risk-weighted assets of the Australian banking business) and the arm's-length amount as calculated for non-ADIs. Non-ADI maximum debt level is the greater of the safe harbour test and the arm's-length debt test.

Budgets

A "giveaway" budget in the **United Kingdom** broadens the starting rate for personal income taxes; introduces a new child tax credit; increases maternity pay; widens the range of pension fund investments; provides a new tax credit for drug companies; reduces capital gains tax; reduces VAT for small business; abolishes some stamp duties; and reduces duty on fuel and cars, freezes it on drinks, and increases it on cigarettes. **Zambia** widened and strengthened its thin capitalization rules. **Belgium** plans to reduce corporate taxes from 40.17 percent to 30 percent (15 percent for small businesses and medium-sized technology companies). **Latvia** reduced the effective non-resident withholding on royalties on, inter alia, works of art, discoveries, and inventions to 15 percent. Tax is withheld at 15 percent on the income of non-residents working in Latvia, including artists and athletes, and on those providing services to Latvian residents or a Latvian PE and on interest; at 10 percent on dividends; and at 2 percent on income from alienation of immovable property and securities. Investment incentives for resident companies include tax reductions for substantial investments and exemptions on dividends from non-tax-haven non-resident companies if a 25 percent voting and equity threshold is met.

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